THE CHANGING ROLE OF THE STATE IN POST-COVID ECONOMIC LIFE

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Abstract During the pandemic – similarly to crises of other nature – the role of the state became more important in many economies. However, there is a question over whether this increased importance will be sustainable. In this paper, the author examines one of the most important fields related to this question – the development of public finances. The analysis focuses on the member states of the European Union (EU). The preliminary conclusion is that in many EU member states, there is more acceptance (and even more claim) for stronger public action (and related public finances), however, the picture is far from monochromatic. The specific issue of supranational (EU) public action is also tackled. The steps induced by the pandemic look promising (and in some aspects, even revolutionary), however, for the time being, the direction and speed of the new processes (potentially leading to more EU-level public action) remain unclear in the long run. Both member state-level and EU-level changes are important in shaping the future of European integration.

Keywords:
European Union, Lisbon strategy, Europe 2020 strategy, COVID-19, Next Generation EU

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1 Introduction

The role of the state is one of the aspects most often analysed by researchers aiming to understand the functioning of today's economic mechanisms.[1] In times of crisis, changes in this role can be observed, which may not only have short-terms effects, but also potentially long-term. The 1929-1933 world economic crisis brought – among many other effects – substantial novelties in economic analysis as well as in the definition of the (potential) role of the state. Since then, the world has changed much – as has the world economy – however, the debate between the different approaches (schools) has remained.

In the 21st century to date, two major events have added new input to this debate – the 2008 world financial and economic crisis and, more than a decade later, the COVID-19 pandemic.[2] In this study, the author discusses the effects of these two events on government finances in European Union (EU) member states and on the finances of the EU. In both cases, the public finances of EU member states have shown a considerable expansion that may (at least partially) also persist in the long run. In terms of EU finances, there have been some structural changes as a reaction to the 2008 crisis, however the pandemic caused a big leap ahead – the historic decision to pursue joint borrowing of the member states. The study ends with concluding remarks related to potential future developments relating to the role of the state in the EU.

2 The effects of the crises on public spending in EU member states

The 2008 world financial crisis and the COVID-19 pandemic marked substantial breaking points in the economic development of most countries in the world. Though for different reasons (and also following a different pattern in the two cases), economic activity has relented and the decline in GDP has caused deep economic and resulting social problems. These effects could be identified (even if not exactly quantified) from the beginning of the crises, therefore the reaction of the state was a logical step, particularly as it was clearly expected by the public.

[1] The development of the role of public finance has been a very complex process, however, due to space limitations, this paper is not able to cover this area in detail. A compact but thorough analysis (Tanzi, 2008) presents the main elements of this development during the 20th century, also outlining scenarios (with related key issues) for the future.
[2] Currently, it is impossible to estimate the effects of the war launched by Russia on 24 February 2022 in Ukraine in this respect. However, it is very likely that it will have an effect on public spending (as a result of potentially higher defence expenditure in many countries).

Figure 1 illustrates the share of government spending in GDP in the European Union from 1997 to 2020. While the bars present averages, the trends are clear: the consequences of the 2008 world financial and economic crisis, as well as those of the COVID-19 pandemic, are reflected in an increase in the share of government spending. In both cases, a relatively long downward trend has been interrupted. For the first crisis, a decrease of the share after the shock can be seen, while for the second, it is not possible to be certain about future trends (the event is still very recent and its effects are still being felt). It must be noted that in March 2022, the consequences of the war launched by Russia in Ukraine may add a new factor of uncertainty, leading to, among others, a further potential increase of the share of government spending in GDP.

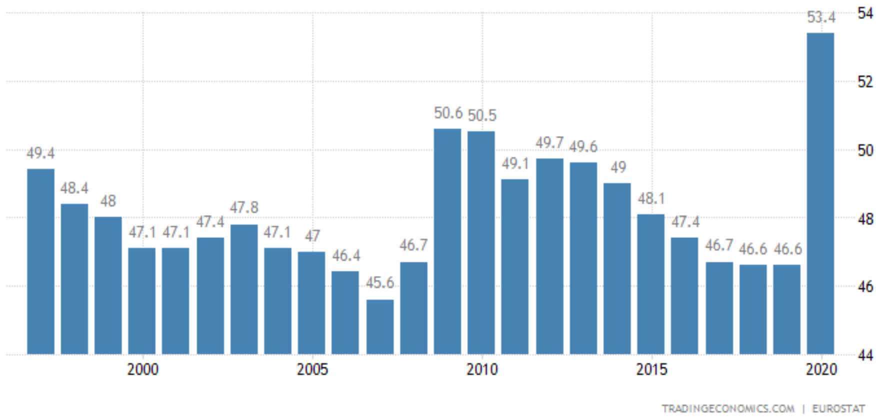

Figure 1: The share of government spending in GDP in the EU, 1997-2020 (%)
Source: https://tradingeconomics.com/european-union/government-spending-to-gdp

The effects of both crises on government finances can also be clearly seen in the increase in the share of public deficits. Figure 2 illustrates the development of the government deficit/GDP ratio between 1997 and 2020. Extremely high values of deficit can be seen in 2009 and 2010 (when the effects of the 2008 crisis had to be handled) and in 2020 when measures had to be taken to deal with the COVID-19 shock. In both cases, the need for extra finances arose at a time when GDP had contracted, meaning that there was no growth that could have created additional financial resources – in fact, it was the complete opposite.

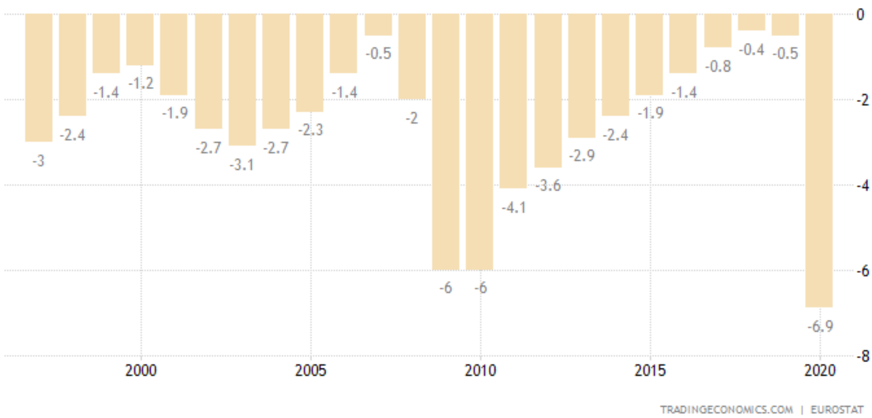

Figure 2: The share of government deficit in GDP in the EU, 1997-2020 (%)
Source: https://tradingeconomics.com/european-union/government-budget

It is important to emphasise that Figure 2 (as well as the other Figures in this paper) show averages in the EU. Beyond the averages, there are considerable differences between the developments of the indicators of the individual member states. These differences are most striking in the case of government deficit and its share in GDP. In the case of the 2008 world financial and economic crisis (and the Eurozone crisis that followed – see Scheinert, 2016 for links between the 2008 crisis and the Eurozone crisis), Ireland was the extreme case, with a 32.1% ratio in 2010 (following an already extremely high 13.9% ratio in 2009), as a result of the spending necessary to stabilise the banking system.[3] Greece was another specific case, and there have been many member states that have shown more or less important deviations from the trend shown by the development of the average value.

The need for an increased role of the state – in partly different fields during the different crises – together with a decline in economic performance during the crises has logically resulted in increasing public debt. Figure 3 shows the development of government debt in the EU between 2000 and 2020. The long-lasting effects of the 2008 world financial and economic crisis are evident: after stabilisation of the public debt/GDP ratios in the 1990s and maintaining the ratio at a manageable level (also

[3] The government spending/GDP ratio in Ireland was 65.1% in 2010. The Irish case is also interesting because the country had a relatively low (30-35%) government spending/GDP ratio prior to 2008 and its values changed to even lower levels (below 30%) after the costly but successful management of consolidation of the financial sector (all data in the text and the footnotes are Eurostat data via tradingeconomics.com).

to be in line with the related Maastricht criterion), the financing of the needs of the crisis led to substantially higher debt/GDP ratios (for a detailed analysis, see Szczepanski, 2019).

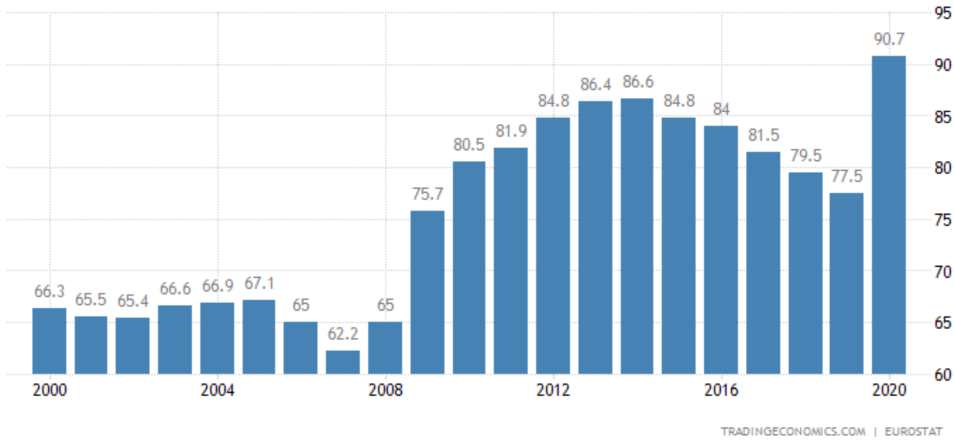

Figure 3: The share of government debt in GDP in the EU, 2000-2020 (%)
Source: https://tradingeconomics.com/european-union/government-debt-to-gdp

It is important to note that after the shock of the 2008 world financial and economic crisis (as well as the Eurozone crisis), while the increasing trend of the ratio reverted after 2014, the values did not return to the levels experienced before 2009. While in 2008, the EU average government debt/GDP ratio was 65%, in 2019 (the year before COVID-19), it was 77.5 %. It is from this 'increased basis' that the value increased abruptly in 2020 as a result of the pandemic and the measures taken (and financed) by the states.

3 Effects on the EU budget

Both crises have had an effect on EU-level public spending.[4] As for the 2014-2020 multiannual financial framework (MFF), strengthening the competitiveness of the European Economy has been a central element from the outset of its planning (European Commission, 2011). Competitiveness was not a new element at that time,

[4] The EU budget differs in many ways from national budgets. It has far more limited resources; its resources are different form the ones that are available for national budgets. Regarding spending, the EU budget is aimed at contributing to the realisation of selected EU policies. The changes described in the paper have to be judged bearing these limitations in mind.

as it had already gained an important place in the 2007-2013 MFF, which meant a change in the focus of managing traditional common policies and enlargement in the previous (2000-2006) period. The new component in the 2014-2020 MFF was that it also tried to react to the experiences of the crises (the world financial and economic crisis and the Eurozone crisis). Of course, this was only possible to a very limited extent as a result of the limited size of the EU budget. As has been demonstrated, public finances in the member states expanded in this period; from the EU side, it is the framework (the regulatory setup of the Economic and Monetary Union, the deepening of the content of economic policy coordination) that has reacted the most tangibly. While such changes have also shown signs in the EU budget, without extra financing, these changes remain more demonstrative than decisive.

In the case of the COVID-19 pandemic, the crisis hit in the middle of the planning process of the 2021-2027 MFF. The initial proposal of the European Commission (European Commission, 2018) contained several reform elements, however, of course, it was not able to foresee the additional huge task that arrived with the pandemic. Therefore, a specific arrangement was needed, which was agreed upon by the leaders of the member states in July 2020 (European Council, 2020). This agreement – including the Next Generation EU instrument – formed part of the final agreement on EU finances for the 2021-2027 period, agreed upon in December 2020 (Council of the European Union, 2020).

The Next Generation EU instrument (a EUR 750 billion (2018 prices) package of external financing of loans and expenditure)) includes an important novelty: long-term joint borrowing of the member states. Joint borrowing was inconceivable in the past, while 'long-term' really is long: repayment is due by the end of 2058 at the latest. (European Council, 2020).

As can be seen, both the member states and the EU have reacted to both crises. In the second of the two, the EU's reaction is also incorporated in finances (unlike in the first one). While this may have an importance for the future of EU financing and of the integration itself (will the EU develop towards fiscal federalism, or, more generally, towards federalism?), due to the amounts at stake, changes in member state budgets can bring far deeper changes.

4 Concluding remarks

The changes discussed above can have substantial effects on the economies of EU member states and the EU itself. Recent trends suggest an increasing role of public action, both in the member states and at the level of their integration.

With an increasing role of public finances, several questions arise:

- How will these potentially larger public finances be used? What will be the main areas at the member state level? Will we see new common policies emerging at the EU level?

- Will the stability criteria rules of the Economic and Monetary Union (EMU) change, and if so, how? How will eventual changes influence the future of the EMU?

- How will the eventual changes in the role of public finances influence the competitiveness of the EU and its member states – depending, of course, on changes in other countries and areas of the world?

- Will the EU develop towards a federation (as a result of – not only – a potentially larger EU budget and potential new forms of joint financing efforts)?

The above questions are of key importance and are currently open, hence it is impossible to answer them with certainty. The history of the European integration process, however, gives ground to certain optimism: it has always been that case that in critical situations, the integration has been able to produce something new that was able to further the integration from a previous deadlock. Today, Europe is facing unprecedented challenges, however, if history repeats, then it will be able to overcome these challenges and become stronger than before.

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